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No. 89-1965

In the Supreme Court of the United States

OCTOBER TERM, 1990

COTTAGE SAVINGS ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a substantially identical group of mortgage loans held by another financial institution.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-15a) is reported at 890 F.2d 848. The opinion of the Tax Court (Pet. App. 16a-56a) is reported at 90 T.C. 372.

JURISDICTION

The judgment of the court of appeals (Pet. App. 57a) was entered on December 4, 1989. A petition for rehearing was denied on March 14, 1990 (Pet. App. 58a). The petition for a writ of certiorari was filed on June 11, 1990, and granted on October 1, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS AND REGULATION INVOLVED

The relevant portions of Sections 165 and 1001 of the Internal Revenue Code of 1954 (26 U.S.C. (1982)) and Section 1.1001-1(a) of the Treasury Regulations on Income Tax (26 C.F.R.) are set forth at Pet. Br. App. 1a-4a.

STATEMENT

1. Petitioner is a mutual savings and loan association formerly regulated by the Federal Home Loan Bank Board.[1] In 1980, petitioner's mortgage loan portfolio contained many fixed-rate, long-term home mortgage loans that had been issued at interest rates significantly lower than those charged on more recent loans. As a result of the high interest rates of the late 1970s and early 1980s, the fair market value of these older, low-interest loans fell far below their face amount. Pet. App. 2a, 18a.

For petitioner, like other savings institutions holding older, low-interest loans, this situation created a tax incentive for disposing of its depreciated mortgage loans. A disposition of the loans would enable an institution to realize for tax purposes the loss that resulted from these market changes; the institution could then utilize the resulting loss deductions to offset current taxable income and produce loss carrybacks that would generate tax refunds from prior years. There was, however, a problem with a straightforward disposition of the depreciated mortgage loans. Many of these institutions were in such precarious financial condition that a sale of the loans and

[1] In 1989, the Federal Home Loan Bank Board was abolished by statute, and many of its functions were transferred to other federal agencies, including the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. 101-73, § 401, 103 Stat. 354.

consequent recognition of the losses—however beneficial for tax purposes—would for regulatory accounting purposes have caused them to fail to meet the Bank Board's minimum reserve and liquidity requirements. See Pet. App. 1[illegible]a-19a; *San Antonio Savings Ass'n* v. *Commissioner,* 887 F.2d 577, 579 (5th Cir. 1989), petition for cert. pending, No. 89-1928.

On June 27, 1980, the Bank Board's Office of Examination and Supervision (OES) issued Memorandum R-49, a regulatory accounting principle that adopted the rule that savings institutions could make "reciprocal sales" of "substantially identical mortgage loans" without having to record a loss for regulatory accounting purposes. Pet. App. 19a, 59a-60a. Memorandum R-49 established a list of ten criteria that would render loans "substantially identical," including that the mortgages be of similar type with the same terms and interest rates.[2] The admitted objective

[2] Memorandum R-49 provided in part (Pet. App. 59a-60a):

A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:

1. involve single-family residential mortgages,
2. be of similar type (e.g., conventionals for conventionals),
3. have the same stated terms to maturity (e.g., 30 years),
4. have identical stated interest rates,
5. have similar seasoning (i.e., remaining terms to maturity),
6. have aggregate principal amounts within the lesser of 2 ½% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

of Memorandum R-49 was to allow savings institutions to engage in transactions that would generate deductible losses for federal income tax purposes, but that would not be treated as giving rise to losses for financial reporting and regulatory purposes. *San Antonio Savings Ass'n* v. *Commissioner,* 887 F.2d at 579-580; Pet. App. 20a-22a.[3]

2. On December 31, 1980, petitioner entered into four separate transactions with four other savings institutions designed to exchange interests in mortgage loans that satisfied the requirements of Memorandum R-49. In each transaction, petitioner effectively exchanged a package of 90% participation interests in a group of residential mortgage loans for a package of 90% participation interests in a group of residential mortgage loans held by the other institution. Pet. App. 24a-27a, 32a-33a.[4] In each transaction, the participation interests exchanged were in loan packages having almost identical face and market value (*id.* at 25a), and the loans involved were "substantially identical" according to the criteria set forth in Memorandum R-49 (*id.* at 30a). In selecting loans to be exchanged, petitioner and its trading partners did not investigate the credit ratings of any of the borrowers on the loans they received and did not investigate the value of the real estate that secured the loans. *Id.* at 4a, 28a. The pricing or valu-

[3] A memorandum from the Director of OES to an officer of the Bank Board described the "objective" of Memorandum R-49 as being "to structure a transaction which was as close as possible to the IRS 'materially different' definition which would still not change the economic position of the association after it engaged in the swap." Pet. App. 21a; see *San Antonio Savings Ass'n* v. *Commissioner,* 887 F.2d at 580.

[4] Transactions designed to take advantage of Memorandum R-49 often involved exchanges of 90% participation interests, rather than the entire loan, so that the original mortgagee could maintain its relationship with the obligor on the loans. Pet. App. 27a-28a.

ation of all the loans was established by using one common discount factor based on the then-current interest rate of 14.863%. *Id.* at 3a, 25a.

Each transaction was consummated in the form of a "reciprocal sale" by conveyance of the 90% participation interests together with a simultaneous transfer of checks by both parties in the amount of the fair market value of the interests acquired (Pet. App. 3a-4a, 24a-25a). Petitioner paid a total of $4,456,912 and received a total of $4,458,855 in the four transactions (*id.* at 25a).[5] The participation interests that it transferred had a face value of $6,907,208 (*id.* at 27a). On its 1980 federal income tax return, petitioner claimed a deduction for a loss on the transactions in the amount of $2,447,091. Exh. 9-1.[6] Pursuant to Memorandum R-49, petitioner did not report any loss for financial and regulatory accounting purposes (Pet. App. 2a, 30a).

3. On audit, the Commissioner determined that petitioner was not entitled to its claimed deduction for a loss on the mortgage exchange transactions. Petitioner sought redetermination of the resulting income tax deficiencies in the Tax Court. After a trial, the Tax Court held for petitioner (Pet. App. 16a-56a).

The Commissioner's primary argument in the Tax Court was that a loss is "realized" for tax purposes under Section 1001 of the Internal Revenue Code[7] on an exchange of

[5] All figures are rounded off to the nearest dollar.

[6] On its return, petitioner arrived at its claimed loss of $2,447,091 based on a "gross sales price minus expenses of sale" of $4,425,416, and "cost or other basis" of $6,892,506. Exh. 9-1. Petitioner carried back its loss to the years 1974-1979. Pet. App. 31a n.6.

[7] Unless otherwise indicated, statutory references are to the Internal Revenue Code of 1954 (26 U.S.C. (1982)), as in effect for the year at issue (the Code or I.R.C.).

property only if the exchanged properties are "materially different," and that mortgages that were "substantially identical" under the Memorandum R-49 criteria were not materially different. The Tax Court concluded that the loans petitioner transferred were "materially different" from the loans it received because the loans had different borrowers and were secured by different collateral (Pet. App. 40a-45a). The Tax Court also rejected the Commissioner's additional argument that no loss could be deducted under Section 165 of the Code because the exchange lacked economic substance (*id.* at 51a-52a).

4. The court of appeals reversed (Pet. App. 1a-15a). The court agreed with petitioner's position that a loss was "technically realized" (*id.* at 10a) on the R-49 exchange of mortgages because, in the court's view, Section 1001 of the Code does not require that exchanged properties be "materially different" in order for an exchange to constitute a realization event (*id.* at 9a-10a). The court held, however, that because the exchange of mortgages pursuant to Memorandum R-49 did not result in any real change in petitioner's economic position, petitioner had not sustained a loss on the transactions that would permit it to take a loss deduction under Section 165 of the Code (Pet. App. 10a-15a). In particular, the court stated that loss deductions are not allowed on "transactions in which the taxpayer's economic position was not changed for the worse" (*id.* at 12a-13a), and it concluded that "[petitioner's] economic position was not changed" by an exchange of a pool of mortgages for "a substantially identical pool of mortgages" (*id.* at 14a).

SUMMARY OF ARGUMENT

This case presents the same question as the first question presented in *United States* v. *Centennial Savings Bank FSB (Resolution Trust Corporation, Receiver),* No. 89-

1926 – whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a "substantially identical" group of mortgage loans in a transaction that complied with the criteria set forth in Federal Home Loan Bank Board Memorandum R-49. As we explain in our brief in *Centennial,* the exchanges of mortgage loans at issue do not produce deductible losses because (1) in order for an exchange of property to produce a deductible loss, the property transferred must be materially different from the property received, and (2) the property transferred in the exchanges at issue is not materially different from the property received.

The Internal Revenue Code takes increases and decreases in the value of property into account only when they are "realized" by a taxable event. See I.R.C. § 1001(a). Under the Commissioner's longstanding interpretation, an exchange of property is not a realization event unless it involves "property differing materially either in kind or in extent." Treas. Reg. § 1.1001-1(a). This materially different aspect of the realization requirement has long been recognized by courts and commentators. The Commissioner's interpretation – embodied in Treasury Regulations for the past 55 years – is reasonable and should be upheld. *Chevron U.S.A. Inc.* v. *NRDC, Inc.,* 467 U.S. 837, 842-843 (1984); *National Muffler Dealers Ass'n* v. *United States,* 440 U.S. 472, 476-477 (1979).

Petitioner argues that the Commissioner has been wrong all these years, and that Section 1001 actually precludes a "materially different" requirement. Petitioner contends that Section 1001(c) of the Code requires realization of gain or loss on all exchanges, unless one of the Code's specific nonrecognition provisions applies. That is an incomplete reading of the text of Section 1001(c). What

Section 1001(c) actually provides is that the gain or loss "determined under this section" shall be recognized, except as otherwise provided in the Code. Whether gain or loss is "determined under this section" depends on whether there has been a realization event. Realization and recognition are separate events in determining the tax consequences of a transaction. The Commissioner's Regulation is a sound and reasonable interpretation of what constitutes realization in the context of a property exchange under Section 1001. Contrary to petitioner's contention, the legislative history of the predecessors of Section 1001 does not indicate that gain or loss necessarily is realized on every exchange of appreciated or depreciated property for different property.

Petitioner's other objections to the materially different requirement are also misconceived. Petitioner mistakenly contends that three early tax decisions of this Court—*Eisner* v. *Macomber,* 252 U.S. 189 (1920); *Weiss* v. *Stearn,* 265 U.S. 242 (1924); and *Marr* v. *United States,* 268 U.S. 536 (1925)—preclude the materially different requirement; in fact, those decisions are entirely consistent with such a requirement. Petitioner also argues that the "materially different" requirement is at odds with the specific nonrecognition provisions of Section 1031, which governs "like kind" exchanges, and Section 1091, which governs "wash sales" of stock or securities. That petitioner's mortgage swap transactions did not fall within these specific non*recognition* provisions, however, does not mean that a loss was *realized.* Finally, petitioner's claim that a materially different requirement will lead to administrative difficulties is speculative and implausible, ignores the fact that the requirement has been in effect for many years and has not led to such problems, and fails to appreciate that it is the Commissioner who is charged by

law with making policy judgments concerning how best to administer and enforce the Internal Revenue Code.

2. A difference is material if it has the capacity to affect a decision. The available evidence from the conduct and intent of the parties, the evaluation of the market, and the expert judgment of the agency charged with regulating the field establishes that the differences in the swapped loan pools were not material. Although petitioner seeks to exclude evidence from each of these sources, the evidence from these sources is highly relevant and should not be categorically ignored. Petitioner also seeks to rely on differences in borrowers and collateral, on the role of 90% participation interests in the transactions, and on the fact that the loan performances eventually differed. Petitioner thus attempts to rely on a list of factors that either were of no significance to any of the interested parties (respondent and its trading partners, the secondary mortgage market, or the Bank Board) at the time of the transaction or were unknown to them at that time. Petitioner's approach would exalt form over substance and severely undermine the efficacy of the realization requirement by allowing differences of no consequence to any interested party to be deemed "material," thereby permitting a deductible loss for federal tax purposes to be generated by transactions that no one regarded as changing the participants' economic position.

ARGUMENT

PETITIONER DID NOT REALIZE A DEDUCTIBLE LOSS ON THE SWAP OF ONE GROUP OF MORTGAGE LOANS FOR ANOTHER SUBSTANTIALLY IDENTICAL GROUP OF MORTGAGE LOANS

This case presents the same question as the first question presented in *United States* v. *Centennial Savings Bank FSB (Resolution Trust Corporation, Receiver),* No. 89-

1926—whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a "substantially identical" group of mortgage loans in a transaction that complied with the criteria set forth in Memorandum R-49. As we explain in our brief in *Centennial,* the exchanges of mortgage loan packages do not produce deductible losses because (1) in order for an exchange of property to produce a deductible loss, the property transferred must be materially different from the property received, and (2) the property transferred in the exchanges at issue is not materially different from the property received.[8]

Petitioner raises three arguments: (1) the Internal Revenue Code does not require that properties be materially different in order for the exchange to produce deductible losses (Pet. Br. 26-43); (2) if there is a materially different requirement, petitioner's exchange of "substantially identical" pools of mortgage loans satisfied that requirement (*id.* at 43-50); and (3) regardless of the materially different requirement, Section 165 does not provide an independent basis for denying a deduction for the exchange of substantially identical pools of mortgage loans (*id.* at 13-26). As we explain in our *Centennial* brief, the most straightforward analysis of the mortgage swaps lies in an application of the materially different requirement; a correct application of that principle is sufficient to reject petitioner's claim to a deduction for the exchange.[9]

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[8] A copy of our brief in *Centennial* has been supplied to petitioner's counsel.

[9] As pointed out in our brief in *Centennial* (at 17 n.12), to the extent that the court of appeals' premise that there is no "materially different" realization requirement in property exchanges is accepted—which, in our view, would be a serious misinterpretation of the Code—we agree with the court below that the deductions nevertheless should be disallowed because the transactions lacked economic substance and thus did not produce losses deductible under Section 165. The same reasons that led to the court of appeals' Section 165 conclusion, however, also should have led it to conclude that the losses were not deductible because the properties exchanged were not materially different. See note 39 *infra*.

A. A Deductible Loss Is Realized On An Exchange Of Property Only If The Property Transferred Is Materially Different From The Property Received

As we show in our *Centennial* brief (at 13), it is well established that the Internal Revenue Code ordinarily takes into account increases and decreases in the value of property only when gains or losses are realized. In the Commissioner's view, this realization requirement is derived from Section 1001(a),[10] taken together with the income and loss provisions of Sections 61(a)(3) and 165(a). Exchanges of property, moreover, present particular issues in applying the requirement of realization. As a result, under the Commissioner's longstanding interpretation, an exchange of property is a realization event only if it involves "property differing materially either in kind or in extent."[11]

Petitioner maintains that the materially different aspect of the realization requirement should be rejected, and that the provision of the Treasury Regulations embodying it

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[10] Section 1001(a) provides:

> The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

[11] See Treas. Reg. § 1.1001-1(a) ("Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property *differing materially either in kind or in extent*, is treated as income or as loss sustained") (emphasis added).

should be invalidated. See Pet. Br. 10, 26, 40-41, 49.[12] The materially different aspect of the realization requirement, however, is well established and properly conceived. It has been in the Treasury Regulations since 1935.[13] The materially different aspect of the realization requirement has been recognized and applied in numerous judicial decisions.[14] It has been equally well recognized by commentators.[15] Indeed, the materially different aspect of the realization requirement is so well known and longstanding that the very structure of the R-49 transactions was based upon an awareness of the requirement.[16]

[12] Petitioner does not contend that the Regulation itself fails to embody a materially different requirement for exchanges of property. Cf. Pet. App. 39a & n.14; 54a-55a. Such a contention would violate the principle that an agency's interpretation of its own regulations is "of controlling weight unless it is plainly erroneous or inconsistent with the regulation." *Udall* v. *Tallman*, 380 U.S. 1, 16-17 (1965). See also *Robertson* v. *Methow Valley Citizens Council*, 109 S. Ct. 1835, 1850 (1989); *Lyng* v. *Payne*, 476 U.S. 926, 939 (1986). The Commissioner's longstanding interpretation of the Treasury Regulation obviously accords with the regulatory language.

[13] See Treas. Reg. 86, Art. 111-1 (1934 Revenue Act). Petitioner points out that an earlier Treasury Regulation (Treas. Reg. 45, Art. 1563 (1920 ed.)) required, among other things, that an exchange of property involve "essentially different" property to be a realization event, and claims that the Commissioner "abandoned" this requirement. Br. 30-31. We fail to see a dramatic difference between the "essentially different" and "materially different" requirements, but, in any event, the materially different language has been in the Treasury Regulations consistently since 1935. Petitioner also points to an isolated ruling in 1935 (Pet. Br. 29 n.20); to the extent that ruling suggests the absence of a "materially different" requirement, it has long been superseded during the 55 years in which the "materially different" requirement has been in the Regulation.

[14] See, *e.g.*, *Mutual Loan & Sav. Co.* v. *Commissioner*, 184 F.2d 161, 162, 165 (5th Cir. 1950); *Emery* v. *Commissioner*, 166 F.2d 27, 29-30 (2d Cir. 1948); *City Bank Farmers Trust Co.* v. *Hoey*, 52 F. Supp. 665, 666 (S.D. N.Y. 1942), aff'd, 138 F.2d 1023 (2d Cir. 1943); *West Missouri Power Co.* v. *Commissioner*, 18 T.C. 105, 109-111 (1952). In the context of the R-49 transactions, two of the three courts of appeals addressing the issue have reaffirmed the validity of the materially different requirement. See *San Antonio Sav. Ass'n* v. *Commissioner*, 887 F.2d 577, 581-587 (5th Cir. 1989), petition for cert. pending, No. 89-1928; *Federal Nat'l Mortgage Ass'n* v. *Commissioner*, 896 F.2d 580, 583 (D.C. Cir. 1990), petition for cert. pending, No. 89-1987. The Tax Court has also applied the materially different requirement in the context of the R-49 transactions. See *Federal Nat'l Mortgage Ass'n* v. *Commissioner*, 90 T.C. 405, 421-422 (1988), aff'd, 896 F.2d 580 (D.C. Cir. 1990), petition for cert. pending, No. 89-1987; Pet. App. 40a.

As we also discuss in our *Centennial* brief (at 15), the reason for the materially different aspect of the realization requirement is readily apparent. In the absence of such a requirement, the tax consequences of a disposition of property — a deduction in the case of a loss, income in the case of a gain — would apply even though the taxpayer's economic position remained essentially the same. By definition, an exchange of property involves property that the exchanging parties treat as having equivalent value. Thus, if the exchanged properties are not materially different, the taxpayer has not changed his economic position: he not only retains property of equivalent value, but that property of equivalent value is also not materially different from what he had before. In the absence of a *materially* different requirement, economically meaningless exchanges of identical property — such as 1000 bushels of

[15] See, *e.g.*, Winterer, *"Reissuance" and Deemed Exchanges Generally*, 37 Tax Law. 509, 512 (1984); R. Magill, *Taxable Income* 143 (rev. ed. 1945).

[16] See Pet. App. 21a (Memorandum from Bank Board entity that issued R-49: "Our objective [in developing the R-49 criteria] * * * was to structure a transaction which was as close as possible to the IRS 'materially different' definition which would still not change the economic position of the association after it engaged in the swap.")

Kansas wheat for a "different" 1000 bushels of Kansas wheat – would constitute realization events and produce tax consequences. See *San Antonio Sav. Ass'n*, 887 F.2d at 583. The end result would be nullification of the realization requirement for losses, since taxpayers with paper losses could engage in repeated meaningless exchanges – say, at the end of every business day in a falling market – and transform those losses into deductions, without altering their economic position. The requirement that exchanged property be materially different if an exchange is to constitute a realization event reflects the fundamental principle of taxation that the substance rather than the form of a transaction determines its tax consequences. See *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945); *Gregory* v. *Helvering*, 293 U.S. 465, 469-470 (1935).[17]

Because the materially different aspect of the realization requirement is a reasonable, longstanding interpretation

[17] Notably, petitioner's position concerning exchanges of identical property – as in the wheat-for-wheat example – is unclear. On the one hand, petitioner's definition of realization (see Pet. Br. 37-38) would seem to require that the exchange constitute a realization event because each party "relinquishes all dominion and control of his asset" in return for the other asset (*id.* at 37). Cf. *San Antonio Sav. Ass'n*, 887 F.2d at 583 (noting taxpayer concession that exchange of identical property is a realization event if there is no materially different requirement and no other specific nonrecognition provision). On the other hand, petitioner seems to indicate that "an exchange of identical property" (Pet. Br. 41 n.36) would not be a realization event. To the extent that petitioner's position is the former, it highlights the importance of the materially different requirement in ensuring that realization is a meaningful concept in exchanges of property. To the extent that petitioner's position is the latter, petitioner has no principled basis, in the absence of a materially different requirement, for excluding exchanges of identical property from the scope of its realization definition.

of the Code, it should be upheld. See *Chevron U.S.A. Inc.* v. *NRDC, Inc.*, 467 U.S. 837, 843 (1984) ("[I]f the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."); *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477 (1979) ("Congress has delegated to the Secretary of the Treasury, and his delegate, the Commissioner of Internal Revenue, not to the courts, the task of prescribing all needful rules and regulations for the enforcement of the Internal Revenue Code") (internal quotation marks and brackets omitted); *United States* v. *Correll*, 389 U.S. 299, 305-307 (1967) ("This case * * * comes within the settled principle that 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.' * * * The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.").[18] Petitioner's request to invalidate the materially different aspect of the realization requirement falls far short of shouldering the formidable burden that such a request entails.

2. Petitioner raises a variety of arguments in support of its claim: the provisions of Section 1001 and their legislative history preclude the materially different requirement (Pet.

[18] In light of the venerable judicial decisions recognizing and applying a materially different requirement to exchanges of property (see note 14, *supra*), it is also appropriate to invoke "the strong presumption of continued validity that adheres in the judicial interpretation of a statute." *Square D Co.* v. *Niagara Frontier Tariff Bureau, Inc.*, 476 U.S. 409, 424 (1986). Here, the Internal Revenue Code long has been interpreted to permit the materially different aspect of the realization requirement.

Br. 26-29); three early tax decisions of this Court preclude the requirement (*id.* at 35-40); the statutory nonrecognition provisions of Sections 1031 and 1091 preclude the requirement (*id.* at 32-33); and the requirement would produce "an administrative nightmare" (*id.* at 42-43). None of these contentions is well founded.

Petitioner first seeks to rely on the provisions of Section 1001 and their legislative history. According to petitioner, Section 1001(a) is purely computational, and Section 1001(c) requires that the consequences of any sale or exchange be recognized unless another non-Section 1001 provision specifically provides for nonrecognition. Petitioner misconstrues these provisions.

As we have noted, the realization requirement is derived from an interpretation of Section 1001(a), taken together with related provisions in Section 61 and Section 165. That Section 1001(a) includes a realization requirement is well recognized. See, *e.g.*, 2 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 40.2, at 40-4 (2d ed. 1990) (Section 1001(a) "implies that increases and decreases in the value of property are not taken into account for tax purposes when they accrue, but only when they are realized by a taxable event") [hereinafter Bittker & Lokken]. Indeed, initially, petitioner agrees that Section 1001(a) includes a realization requirement. See Pet. Br. 14 ("Even though Section 1001(a) is entitled 'Computation of Gain or Loss,' it is understood to include the realization requirement."). Petitioner then shifts ground and contends that Section 1001(a) is entirely computational and does not include a realization requirement. See Pet. Br. 27 ("Sections 1001(a) and (b) merely set forth the manner of computing the amount realized on a transaction, and do not create a statutory standard for realization.").

In contrast, the Commissioner's interpretation of Section 1001(a) is consistent and reasonable. As an initial

matter, we agree that Section 1001(a) does not itself state a *test* for realization; no provision of the Code sets forth a definition of what events are realization events.[19] Nevertheless, although Section 1001(a) is entitled "Computation of Gain or Loss," its use of the term "amount realized" plainly indicates that there *is* a realization requirement. In arguing that Section 1001(a) is purely computational, petitioner relies on legislative history indicating that Section 1001(a) shows "the method of determining the amount of gain or loss from the sale or other disposition of property." H.R. Rep. No. 179, 68th Cong., 1st Sess. 12 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 13 (1924). The realization requirement, however, is necessarily part of the determination of the amount of taxpayer's gain or loss, because if there is no realization event there is *no* gain or loss. The Commissioner's longstanding interpretation of Section 1001(a) – that Section 1001(a) and related provisions reflect a realization requirement, and that as part of that requirement, in an exchange of property, the property must be materially different if the exchange is to be a realization event – is, at the very least, a reasonable construction and should be upheld.[20]

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[19] The realization requirement existed as a judicial doctrine even before the enactment of Section 1001 and its predecessor. See *Helvering v. Horst*, 311 U.S. 112, 115 (1940) ("From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event.").

[20] We agree with petitioner (Pet. Br. 27) that the realization requirement is not found in Section 1001(b), which defines the "amount realized" from the "sale or other disposition of property" as "the sum of any money received plus the fair market value of the property (other than money) received." Section 1001(b) only comes into play *after* the realization requirement has been met; at that point, Section 1001(b) is used to determine the *amount* realized in the transaction. Nothing in Section 1001(b) precludes the interpretation of the realization requirement (and the corresponding materially different requirement) in Section 1001(a) and related provisions.

Petitioner also relies (Pet. Br. 28-29) on Section 1001(c) of the Code, but similarly misconstrues that provision. Petitioner maintains that Section 1001(c) provides that, except as otherwise provided in the Code, all gain or loss is recognized from all exchanges, and that "gains and losses that are recognized must necessarily be realized" (Pet. Br. 28). From these two premises, petitioner argues that Section 1001(c) requires realization of gain or loss on all exchanges, unless one of the Code's specific nonrecognition provisions applies.

Petitioner's first premise is erroneous. Section 1001(c) does not provide that all gains and losses are recognized; it provides, as we explain in our brief in *Centennial* (at 16-17), that all *realized* gains and losses—all gains and losses "determined under this section"—are recognized.[21] See Treas. Reg. § 1.1002-1(a) ("The general rule with respect to gain or loss *realized* upon the sale or exchange of property as determined under section 1001 is that the entire amount of such gain or loss is recognized except in cases where specific provisions of Subtitle A of the Code provide otherwise.") (emphasis added);[22] 2 Bittker & Lokken, *supra*, ¶ 44.1.1, at 44-2 ("Under § 1001(c), gain or loss *realized* on a sale or exchange of property, as determined under § 1001(a), is 'recognized' unless a nonrecognition provision prescribes otherwise.") (emphasis added). Realization and recognition are thus separate steps in de-

[21] Section 1001(c) provides:

> Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

[22] Petitioner's reliance (Pet. Br. 29, 42) on the Treasury Regulations under Section 1001(c), which provide that exceptions to the rule that realized gain or loss is recognized are "strictly construed" (Treas. Reg. § 1.1002-1(b)), is misplaced. The Regulation, like the statute, applies only to *realized* gains or losses. See Treas. Reg. § 1.1002-1(a).

termining the tax consequences of a transaction.[23] Once again, at a minimum, the Commissioner's interpretation of Section 1001(c) and its relationship to Section 1001(a), as embodied in the Treasury Regulations, is a reasonable construction and should be upheld. *Chevron, Inc.*, 467 U.S. at 843; *National Muffler Dealers Ass'n*, 440 U.S. at 477.

In an attempt to bolster its statutory argument, petitioner also seeks to rely (Pet. Br. 28) on the legislative history of the predecessor of Section 1001(c), Section 203(a) of the Revenue Act of 1924, ch. 234, 43 Stat. 256. Section 203(a) of the 1924 Act was enacted because Congress was dissatisfied with the provision of Section 202(c) of the Revenue Act of 1921, Tit. II ch. 136, 42 Stat. 230, which provided, in pertinent part, that "no gain or loss shall be recognized [on an exchange of property] unless the property received in exchange has a readily realizable market value." The Committee Reports on the 1924 Act stated that this provision "is so indefinite that it cannot be applied with any accuracy, nor with consistency." H.R. Rep. No. 179, *supra*, at 13; S. Rep. No. 398, *supra*, at 14. Accordingly, Congress provided instead, in Section 203(a) of the 1924 Act, that "[u]pon the sale or exchange of property the entire amount of the gain or loss, determined under section 202"—*i.e.*, the entire amount of *realized* gain or loss—"shall be recognized, except as hereinafter provided in this section." Nothing in Section 203(a) or its

[23] The statutory distinction between realization and recognition was, perhaps, easier to see in the 1954 version of the Code, in which the recognition rule of present-day Section 1001(c) stood alone in its own section of the Code, Section 1002. The provision of old Section 1002 became Section 1001(c) in 1976. Tax Reform Act of 1976, Pub. L. No. 94-455, Tit. XIX, § 1901(a)(121), 90 Stat. 1784. This amendment was not intended to have any substantive effect. See S. Rep. No. 938, 94th Cong., 2d Sess. 491, 550 (1976).

legislative history supports petitioner's argument that every exchange of property is a realization event. In stating that elimination of the "readily realizable market value" requirement would produce "definiteness and accuracy" in determining when gain or loss is recognized and in related comments (H.R. Rep. No. 179, *supra*, at 13; S. Rep. No. 398, *supra*, at 14), the Committee Reports are discussing recognition, not realization.[24]

3. Petitioner argues that this Court's decisions in *Eisner* v. *Macomber*, 252 U.S. 189 (1920), *Weiss* v. *Stearn*, 265 U.S. 242 (1924), and *Marr* v. *United States*, 268 U.S. 536 (1925), support its position that the materially different requirement should be invalidated. Pet. Br. 35-40. The

[24] Contrary to petitioner's suggestion (Pet. Br. 30-35), moreover, nothing in the legislative history of the 1924 Act indicates that Congress was dissatisfied with the Treasury Department's view of the realization requirement, as then expressed in Treas. Reg. 45, Art. 1563 (1920 ed). As we have noted (note 13, *supra*), prior to the enactment of the Revenue Act of 1924, that Regulation provided a realization requirement for an exchange – gain or loss was realized from the disposition of property when the property was "converted into cash," or converted into property "that [was] essentially different from the property disposed of * * * In other words * * * a change in substance and not merely form * * * [was] required to complete or close a transaction from which income may be realized." Accord, Treas. Reg. 62, Art. 1564 (1921 Revenue Act). Far from repudiating the Treasury Regulation, Congress intended Section 202(a) of the 1924 Act to "embod[y] in the law the present construction by the [Treasury] department * * * of the existing law" (H.R. Rep. No. 179, *supra*, at 12; S. Rep. No. 398, *supra*, at 13), and the enactment of Sections 202(a) and 203(a) of the 1924 Act clearly does not evidence congressional rejection of the Regulation's "essentially different" requirement.

Petitioner also incorrectly implies (Pet. Br. 31) that the legislative history of the earlier 1921 Act suggests that Congress was dissatisfied with the "essentially different" standard. The Senate Report cited by petitioner says nothing about the essentially different standard, and, therefore, does not evidence congressional disapproval. S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (1921).

Fifth Circuit correctly rejected a similar argument in *San Antonio Sav. Ass'n* v. *Commissioner*, 887 F.2d 577, 583-585 (1989), petition for cert. pending, No. 89-1928. The Fifth Circuit concluded that, in contrast to petitioner's position, these cases fully support the proposition that "the receipt of something materially different ('a thing really different') from that which the taxpayer had previously is necessary for an exchange to be considered a realization event." *Id.* at 583 (quoting *Weiss*, 265 U.S. at 254).

In *Eisner* v. *Macomber*, the Court held that a pro-rata dividend of common stock to the holders of common stock was not "income" to the shareholders within the meaning of the Sixteenth Amendment. The Court reasoned that there was no basic change in the position of the corporation and its shareholders; the stock dividend "does not alter the preexisting proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share." 252 U.S. at 211. A stock dividend is not a "realization of profits of the stockholder." *Ibid.* Rather, "the corporation is no poorer and the stockholder is no richer than they were before." *Id.* at 203 (quoting *Towne* v. *Eisner*, 245 U.S. 419, 426 (1918)). Petitioner correctly observes that *Eisner* v. *Macomber* established that a mere increase or decrease in the value of property does not constitute gain or loss, and that some event is required for realization of gain or loss. Pet. Br. 35-37. But *Eisner* provides no support for petitioner's corollary that "[g]ain or loss, if any, is realized on an asset at the point at which the taxpayer relinquishes all dominion and control of his asset." *Id.* at 37. Indeed, subsequent decisions of this Court concerning stock dividends held that such dividends

may be taxed—not pursuant to petitioner's "dominion-and-control" formula—but based on whether the stock dividend left the recipient in an "essentially different" economic position with respect to his stock after the dividend.[25]

In *Weiss*, the Court applied the principles of *Eisner* v. *Macomber* to an exchange. In *Weiss*, a corporation was liquidated, its assets were transferred to a new corporation, and the old stockholders received half of the stock in the new corporation as well as cash circuitously transferred by new investors. In effect, a stockholder sold half his stock for cash, and received stock in the new corporation in exchange for the other half of his stock in the old corporation. The Court held that no gain was realized on the exchange of the stock because there was merely a "change for purposes of reorganization in the technical ownership of an enterprise * * * followed by issuance of new certificates." 265 U.S. at 254. "Something more is necessary" for realization, the Court observed, "something which gives the stockholder a thing really different from what he theretofore had." *Ibid.* The Court's reference to "a thing really different" certainly is consistent with the conclusion that, for an exchange to constitute a realization event, the taxpayer must receive property that is materially different from the property he gave up.

In *Marr*, a new corporation was organized in a different State to take over the assets and assume the liabilities of an old corporation. The Court held that a taxpayer who received stock in the new corporation in exchange for his stock in the old corporation realized a gain on the exchange. The Court concluded that "the new corporation

[25] See, *e.g.*, *Helvering* v. *Sprouse*, 318 U.S. 604, 607-608 (1943); *Koshland* v. *Helvering*, 298 U.S. 441, 445-446 (1936). See generally, B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 7.41 (5th ed. 1987).

[was] essentially different from the old," because a corporation organized in one State did not have the same rights and powers as a corporation organized in another State. 268 U.S. at 541. The Court also examined the characteristics of the stock itself, concluding that six percent nonvoting preferred stock was "essentially different" from seven percent voting preferred stock, and that the old and new common stock were "essentially different" because they were subject to different amounts of preferred stock priorities and to different amounts of annual dividends on the preferred stock. *Ibid.*[26] Thus, in *Marr*, the Court carefully examined the character and significance of the differences in the exchanged property in determining whether a realization event had occurred.

In sum, this Court in *Weiss* focused on whether the taxpayer received something "really different" (265 U.S. at 254) and in *Marr* focused on whether the taxpayer received something "essentially different" (268 U.S. at 541). The requirement that property exchanged must be materially different for gain or loss to be realized is completely consistent with the Court's focus in those cases. See *Emery* v. *Commissioner*, 166 F.2d 27, 29 & n.6 (2d Cir. 1948) (equating the Treasury Regulation's "materially different" requirement with the *Weiss* test that the exchange must give the taxpayer "something * * * really different from what he theretofore had").[27]

[26] The Court distinguished *Weiss* on the ground that, in *Weiss*, the old and new corporations were organized in the same State and there was no change in the character of the stock. 268 U.S. at 541. See also *id.* at 540 (agreeing with the government that, "in the case at bar, the gain actually made [was] represented by securities with essentially different characteristics in an essentially different corporation").

[27] In *Emery*, the court held that the taxpayer realized a gain on the exchange of municipal bonds for new bonds of the same issuer because "the new bonds did differ materially from the old." 166 F.2d at 29.

Petitioner, however, contends that *Weiss* and *Marr* preclude the application of a materially different requirement to exchanges of different property. Pet. Br. 38-40. Petitioner acknowledges that *Weiss* and *Marr* establish and reflect a "materially different" requirement for realization in certain situations. See *id.* at 38. But, according to petitioner, this requirement is limited to a situation in which a taxpayer exchanges an *interest* in property for an *interest* in the same property, rather than when the taxpayer exchanges property for different property. See *ibid.* ("The cases conclude that a taxpayer may realize gain or loss with respect to property *without disposing of his interest in the property,* if he receives an interest in the property that is 'essentially' or 'materially' different from his original interest in the same property.") Thus, in petitioner's view, *Weiss* and *Marr* hold only that, where a taxpayer exchanges his interest in property for a different (but not materially different) interest in the same property, no realization event has occurred. Petitioner offers no sound reason, however, for its assertion that a different rule should apply when a taxpayer exchanges property for different (but not materially different) property. In either situation, the taxpayer winds up with something not materially different from what he had before, and the same reasons for finding non-realization should govern.

4. Petitioner also contends that the "materially different" requirement for realization is inconsistent with the nonrecognition provisions of Sections 1031 and 1091 of

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Petitioner's assertion that "[t]he new bonds were convertible into registered form, but were identical in all other respects" (Pet. Br. 40) is incorrect. The Second Circuit observed that "[t]he interest rate of the new bonds was substantially less after the call dates of the old bonds; the new bonds matured from one to 23 years earlier than the old bonds; and the period during which the city optionally might call in the bonds was shortened." 166 F.2d at 29.

the Code. Pet. Br. 32-33, 41-42. This contention is mistaken. Section 1031 generally provides that no gain or loss is recognized on the exchange of certain kinds of property for "property of a like kind." Section 1031(a). Section 1091 generally disallows losses from "wash sales" of stock or securities—situations in which the taxpayer acquires "substantially identical stock or securities" within 30 days of the sale. Section 1091(a).

Petitioner's argument assumes that the Commissioner's "materially different" requirement would bar realization in each of the situations covered by Sections 1031 and 1091, rendering those nonrecognition provisions superfluous. That assumption is wrong. Section 1031 deals with exchanges of "like kind" property, a much broader concept than property that is not materially different. "Like kind" refers to general classes of property, such as real property. See generally *Commissioner* v. *Crichton,* 122 F.2d 181, 182 (5th Cir. 1941); Treas. Reg. § 1.1031(a)-1(b) and (c). Accordingly, an exchange in which gain or loss is *realized* because the property is materially different (*e.g.,* two parcels of real property) may nonetheless, because the property is of like kind, result in no *recognition* of gain or loss under Section 1031. Indeed, an exchange of urban commercial real estate for a farm (Treas. Reg. § 1.1031(a)-1(c)) or of an outfielder for a third baseman (see Rev. Rul. 67-380, 1967-2 C.B. 291)) would qualify as a like kind exchange under Section 1031, but obviously would involve property that is materially different.

Section 1091 concerns sales and purchases of certain property—substantially identical stock or securities—that take place within thirty days of each other. Section 1091 disallows any loss incurred on such a "wash sale." Section 1091 applies regardless of whether the transaction is properly characterized as an exchange, subject to the materially

different requirement for realization. See *Shoenberg* v. *Commissioner*, 77 F.2d 446, 450 (8th Cir.) (predecessor of Section 1091 avoids need for inquiry into whether sale and repurchase were part of a plan), cert. denied, 296 U.S. 586 (1935).[28] Thus, the "materially different" requirement for realization in the context of property exchanges renders neither Section 1031 nor Section 1091 superfluous.

Petitioner also relies on Sections 1031 and 1091 for something of an *expressio unius, exclusio alterius* argument. Neither of the nonrecognition provisions applies to mortgage exchanges. See Pet. Br. 23, 32, 41-42. According to petitioner, that suggests that loss from such exchanges must be realized. Not so. Petitioner's argument confuses recognition and realization.

The materially different requirement is a minimum, threshold requirement that must be satisfied in order for an exchange of property to be a realization event. Sections 1031 and 1091 come into play after (or assuming arguendo that) this threshold requirement is met. Accordingly, the fact that Sections 1031 and 1091 do not apply to many debt obligations in no way indicates that gain or loss is realized on the exchange of debt obligations (or other types of property) that are not materially different.[29]

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[28] Transactions subject to Section 1091 typically do not involve an exchange of stock between buyer and seller, but rather open market sales followed by open market purchases.

[29] Petitioner also relies on the legislative history of Section 1031. Pet. Br. 33. A House Report discussing the exclusion of notes and securities from the nonrecognition rules states that, under Section 1031, gain or loss is "recognized in the case of exchanges of notes or securities." H.R. Rep. No. 704, 73d Cong., 2d Sess. 13 (1934). The Report discusses only recognition. Nothing in the Report states that gain or loss is realized on *all* exchanges of notes or securities. Moreover, the case law (discussed in our *Centennial* brief, at 14) holds otherwise. See *Mutual Loan & Savings Co.* v. *Commissioner*, 184

Sections 1031 and 1091 do not create some automatic rule of realization for any transaction that is not within their terms for nonrecognition.[30] Indeed, courts have long held that sales and purchases of substantially identical securities will not necessarily result in *realization* of gain or loss, even if they are not within the scope of Section 1091 (or its predecessor).[31] This analysis is simply an ap-

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F.2d 161 (5th Cir. 1950) (exchange of municipal bonds was not a taxable exchange); *City Bank Farmers Trust Co.* v. *Hoey*, 52 F. Supp. 665 (S.D.N.Y. 1942) (same), aff'd, 138 F.2d 1023 (2d Cir. 1943); *West Missouri Power Co.* v. *Commissioner*, 18 T.C. 105 (1952) (same).

[30] The difference in scope between Section 1091 and the materially different requirement is readily apparent. Section 1091 deals only with the disallowance of losses from wash sales of stock or securities. The materially different requirement of Treas. Reg. § 1.1001-1(a), in contrast, applies both to gains and losses, and is not limited to any particular type of property. And, as we have explained in text (p. 25, *supra*), Section 1031 obviously differs in scope from the materially different requirement.

[31] See, *e.g.*, *Shoenberg* v. *Commissioner*, 77 F.2d 446, 449-450 (8th Cir.), cert. denied, 296 U.S. 586 (1935); *Horne* v. *Commissioner*, 5 T.C. 250 (1945). See also *Smith* v. *Commissioner*, 78 T.C. 350, 388-389 (1982) (acknowledging wash sale approach outside the scope of Section 1091, but finding that particular transaction was not covered by it); 2 Bittker & Lokken, *supra*, ¶ 44.7.6, at 44-107 (wash sale can be disregarded when the transaction "lacks economic substance").

Petitioner argues that *Shoenberg* is inapposite because it involved a sale and reacquisition of identical property, *i.e.*, corporate stock. Although the instant case involves a sale and reacquisition of "substantially identical" property, the *Shoenberg* court's reasoning, by its explicit terms, is equally applicable here. Where a sale of property "is made as part of a plan whereby substantially identical property is to be reacquired," the loss "is not real" because "the taxpayer has not actually changed his position." 77 F.2d at 449.

Petitioner also suggests that *Horne* is inapposite because, according

plication of the realization requirement. Where a taxpayer disposes of property in a transaction in which he receives property that is not materially different from the property he gave up, he realizes no gain or loss.[32]

5. Petitioner also maintains that the "materially different" standard should be rejected because it would produce an "administrative nightmare." Pet. 42-43. Petitioner's contention is flawed for several reasons. First, petitioner forgets that *it* is the party urging a change in the law and an invalidation of the requirement that has been in the Treasury Regulations for 55 years. Indeed, as we have noted (*supra*, pages 11-13), the requirement has been long recognized by courts and commentators (and by the Bank Board as the very reason for the R-49 transactions). This long established requirement has not produced administrative difficulties or taxpayer confusion in the past, and

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to petitioner, *Horne* was decided under the "like kind" exchange rule of Section 1031. Pet. Br. 21 n.15. Petitioner is incorrect. The *Horne* decision cited the like kind provision by analogy. See 5 T.C. at 285-286. See also *Smith*, 78 T.C. at 388 (citing *Horne* as an example of "nonstatutory wash sale consequences").

[32] Petitioner also seeks to rely on Section 56(g)(4)(E) of the Code (26 U.S.C.), which now provides that, in determining "adjusted current earnings" for purposes of the alternative minimum tax on corporations, "[n]o loss shall be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities." As with Section 1031, however, this Section has a much wider scope than the materially different requirement, and it applies to exchanges even if they satisfy the materially different requirement. Petitioner's suggestion that the statutory provision and the R-49 criteria are coextensive is mistaken. As Memorandum R-49 recognizes, debt obligations have many characteristics besides interest rates and maturities. See Pet. App. 59a-60a. Indeed, interest rates and maturities are only two of the ten characteristics that must be common to two or more mortgage loans before the loans may be considered "substantially identical" under the Bank Board's Memorandum R-49. *Ibid.*

there is no reason to think that it would in the future. As we show in our *Centennial* brief (at 17-18), moreover, the principle of materiality is hardly a novel concept in the law.

Second, petitioner is incorrect in stating that upholding the materially different requirement will usher in a new era of tax shelters. As an initial matter, petitioner's professed concern for eliminating opportunities for tax avoidance needs to be taken *cum grano salis*, given that petitioner – according to the factual findings of the Tax Court (Pet. App. 31a, 35a & n.9) – entered into these transactions "solely" for the purpose of tax avoidance. Petitioner's argument is, in any event, untenable. The specter of taxpayers with appreciated property shielding their gains by exchanging the property for substantially identical property (when they need only keep their existing property to avoid tax consequences) is fanciful.[33]

Third, and of particular importance, Congress charged the Commissioner, not petitioner, with making appropriate judgments about administrability. The question is whether the materially different requirement is a permissible interpretation of the Internal Revenue Code, not whether petitioner would exercise administrative discretion in a different fashion. The Commissioner's longstanding position that, in order for an exchange of property to be a realization event, the property exchanged must be materially different, is reasonable and sound, and should be upheld.

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[33] This is not to deny that, as some of the early materially different cases reveal, there may be circumstances in which it is advantageous for a taxpayer to attempt to claim that property in an exchange was not materially different. It is to say, however, that petitioner's professed fears of a massive tax shelter are greatly exaggerated. Indeed, to the extent that the Commissioner's materially different rule may, in some circumstances, operate to the benefit of taxpayer, it illustrates only that the rule is even-handed and founded on a neutral principle.

B. The Mortgage Loans Exchanged By Petitioner Were Not Materially Different

We explain in our brief in *Centennial* (at 17-18) that a material difference is a difference that has the capacity to affect a decision. We then demonstrate (*id.* at 18-26) that the available evidence from (1) the conduct and intent of the parties, (2) the evaluation of the pertinent market (the secondary mortgage market), and (3) the determination of the agency charged with regulating federal savings and loan associations (the Bank Board), confirms that the differences in the mortgage pools exchanged in *Centennial* were not material. Consideration of these factors leads to the same conclusion in this case. The latter two factors—the evaluation of the market and the determination of the Bank Board—are the same in this case as in *Centennial*, and there is no need to restate the discussion from our *Centennial* brief (at 21-26).[14]

As in *Centennial*, the conduct and intent of the parties in this case also establish that the differences in the swapped mortgage pools were not material. Petitioner and its trading partners did not investigate the credit ratings of any of the borrowers on the loans they received and did not investigate the value of the real estate that secured the loans. Pet. App. 4a, 28a. Petitioner made no attempt to determine, on a loan-by-loan basis or an aggregate basis, whether there was a difference between the prepayment potential or anticipated income stream of the loans it re-

[14] Although the Tax Court in this case did not make explicit factual findings concerning the evaluation of the secondary mortgage market, the finding in *Centennial* was generally applicable to the R-49 transactions. See Pet. App. 52a, No. 89-1926 ("[B]ecause information was not available at the time of the transaction regarding individual differences among the loans, the marketplace was unable to and did not differentiate between the pools."). See also Pet. Br. 14 n.5 (noting that the facts of this case are "similar" to the facts of *Centennial*).

ceived and the loans it transferred. *Id.* at 29a. Petitioner and its trading partners drew no distinctions among individuals loans in valuing them. They applied a common discount factor in pricing all of the loans, thereby indicating that they could discern no difference in the overall risk of the loans involved in the exchanges. *Id.* at 3a, 25a. As in *Centennial*, it is thus clear that, with regard to the conduct and intent of the parties, the differences in the mortgage loan pools were not material; the differences did not make a difference.[15]

Petitioner urges that the available evidence from these sources be rejected. With regard to the conduct and intent of the parties, petitioner claims that "objective factors," rather than its "personal views," should be relevant. Pet. Br. 46. As we explain in *Centennial* (at 21), the conduct and intent of the parties, as economic actors, are probative of the objective nature of the transaction, including the materiality of claimed differences, and are an appropriate consideration in the overall evaluation of materiality.

With regard to the evaluation of the market, petitioner contends that it would not be feasible to consider this evidence. Pet. Br. 45-46. As we point out in *Centennial* (at 22), however, courts have long considered the market perspective in analyzing the significance of differences in exchanged properties, and a blanket exclusion of this probative evidence is unwarranted. Petitioner also suggests that

[15] In a triumph of understatement, petitioner acknowledges (Br. 46) that "[i]t is true that [petitioner] may not have been overly concerned with individual differences in the mortgages it exchanged in the R-49 transaction." Cf. Pet. App. 35a-36a n.9 ("[T]he generation of the tax loss deduction was the sole motive for the transactions in dispute."); *id.* at 31a ("The December 31, 1980, transactions were motivated solely by the desire of petitioner and its trading partners to recognize for tax purposes (but not for regulatory purposes) the losses in market values of the loan portfolios each institution owned before the December 31, 1980, transactions.").

the evaluation of the pertinent market should be irrelevant because "[a]ny transaction involving similar assets would be perceived by the marketplace as equivalent." Pet. Br. 46 n.43. As we explain in *Centennial* (at 23 and n.19), there is a fundamental difference between the concept of equivalent value and the concept of material difference, and the evaluation of the secondary market can be quite helpful in considering whether differences are material even if the market (and the parties) assign the properties equivalent value. The point is not simply that the market assigned the same value to the properties exchanged, but rather that the market did not consider the differences now relied on by petitioner to be at all pertinent in arriving at that same value.[36]

Finally, in its application of the materially different requirement (Pet. Br. 43-50), petitioner essentially ignores the fact that the Bank Board determined that mortgage loans were "substantially identical" if they met the R-49 criteria (Pet. App. 59a).[37] As we explain in our *Centennial*

[36] For example, stock certificates of a company typically differ in that each bears a distinctive serial number. The market, however, views certificates of the same class as being of equal value – the difference in serial numbers is not a *material* difference affecting value; it is not a difference the market considers in arriving at value. The market may also happen to value shares of ABC corporation and shares of XYZ corporation at the same price, but this does not mean that the shares are not materially different. Because ABC and XYZ differ in various respects – which the market considers and weighs in arriving at value – the shares are materially different. Here the differences in borrowers and collateral on which petitioner now relies were not differences that the market considered and weighed in concluding that the pools of mortgages had the same value.

[37] Petitioner discusses the role of the Bank Board in its Section 165 analysis (Pet. Br. 16-19), and contends that the R-49 focus on ensuring substantial identity of *risk* is irrelevant; as we show in our *Centennial* brief (at 18-19) and as the Bank Board itself emphasized (Pet. App. 21a-22a), assessment of risk is the core of the secondary mortgage market.

brief (at 23-26), the Bank Board's expert conclusion concerning the significance of differences between packages of mortgage loans is clearly pertinent to consideration of those differences.

Rejecting the relevance of the evidence from the evaluations of the Bank Board, the pertinent market, and the conduct and intent of the parties, petitioner maintains that the pools of loans were nonetheless materially different because (1) the individual loans concern different borrowers, (2) the individual loans are secured by different collateral, (3) each swap was for 90% participation interests, and (4) the loan pools eventually had different performances. Pet. Br. 47. With regard to the first two factors, as we pointed out in our *Centennial* brief (at 26), an across-the-board rule that differences in borrowers and collateral are always material is far too sweeping and fails to take into account differences in contexts and transactions. With regard to the 90% participation interest, such an exchange was a common form of R-49 transaction (see Gov't Br. (*Centennial*) at 4), and that form of the exchange did not itself create material differences in the exchanged mortgage loan pools; indeed, petitioner overlooks the fact that the *exchange* was an exchange of 90% participation interests (Pet. App. 3a-4a, 24a-26a), and thus there was no difference at all in the exchanged loan pools concerning participation interests. With regard to the eventual performance, as we explain in *Centennial* (at 27-28), the question whether the mortgage loans were materially different turns on the significance of whatever differences were known at the time of the exchange, not on a *post hoc* evaluation of subsequent performance.[38]

[38] Petitioner maintains that the decision in *Hanlin* v. *Commissioner*, 108 F.2d 429 (3d Cir. 1939), supports its position. Pet. Br. 47-50. As we explain in *Centennial* (at 27 n.22), this contention is erroneous.

In sum, petitioner seeks to exclude the available evidence from the conduct and intent of the parties, the evidence of the pertinent market, and the expert judgment of the administrative agency charged with overseeing the field. Petitioner seeks instead to substitute a list of factors that made no difference at the time – and, in the particular context, did not have the capacity to make a difference – to the parties, the market, or the agency. Petitioner's approach would strip the concept of materiality of any meaningful content and would accomplish, through application of the materially different requirement, what petitioner also seeks in its direct assault on that requirement – effective elimination, in practical terms, of the requirement itself. Petitioner's attempt should be rejected, and the Commissioner's determination that these exchanges of substantially identical mortgage pools fail to reveal material differences in the exchanged property should be upheld.[19]

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[19] Although the court of appeals held that there is no "materially different" requirement for realization in an exchange of property, the court went on to hold that the deduction of the "loss" was not allowable under Section 165 of the Code. Pet. App. 10a-15a. Applying the principle that purported losses from transactions lacking economic substance are not deductible under Section 165 (see Gov't Br. (*Centennial*) at 16 n.11), the court held that the R-49 exchange did not give rise to a loss deductible under Section 165 because petitioner's "economic position was not changed" by an exchange of a pool of mortgages for a "substantially identical pool of mortgages." Pet. App. 14a. For the reasons we have discussed, the court of appeals' conclusion that there is no materially different requirement under Section 1001(a) is incorrect. As we also note in our *Centennial* brief (at 16 n.11), however, Section 165 and Section 1001(a) are related in that there would be no purpose for Section 1001(a) to provide rules for determining the amount of a loss if Section 165 did not allow a deduction for that loss. Thus, the principle that purported losses from transactions that lack economic substance are not deductible under Section 165 (see Treas. Reg. § 1.165-1(b)) can be viewed as simply another way of saying that

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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no loss is "realized" on such transactions. Accordingly, the same considerations that led the court of appeals to conclude that in substance petitioner had not sustained a loss within the meaning of Section 165 should have led it to conclude that petitioner had realized no loss under Section 1001(a) in the first instance.

To the extent that the court of appeals' premise that there is no materially different requirement is accepted (which would, we believe, be a serious misinterpretation of the Code), we agree that the deductions nevertheless should be disallowed because the transactions lacked economic substance and thus did not produce losses deductible under Section 165. See Gov't Br. (*Centennial*) at 17 n.12.

* The Solicitor General is disqualified in this case.

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